Conference on European Economic Integration 2015: Boosting EU Competitiveness – The Role of the CESEE Countries

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In 2015, the annual Conference on European Economic Integration (CEEI) of the *Oesterreichische Nationalbank (OeNB)* was organized as a joint event with the Conference on the Future of the European Economy (CFEE) of *Narodowy Bank Polski (NBP)*. The joint conference took place in Warsaw on October 15 and 16, 2015, and focused on long-term European growth prospects and competitiveness.[2] Around 260 participants from 30 different countries attended the CEEI/CFEE 2015 to listen to presentations by high-ranking representatives of central banks, international organizations and academia and join the ensuing discussions. The conference offered a wide range of interesting insights e.g. that demographic developments as well as uncertainty regarding migration prospects, future employment contracts and progress in European integration all constitute challenges to economic growth in Europe. Convergence as a central element of European integration has created external imbalances, which manifest themselves today also as weaknesses in the tradable sector. Countries must now identify new sources of sustainable productivity growth. FDI has been a driving force of productivity growth – especially in the Central, Eastern and Southeastern European (CESEE) economies – but needs to be directed more toward the research and development (R&D) sector. Innovation – which is not tantamount to the promotion of high-technology sectors – is important in all segments of the economy, especially in the traditional economic sectors. Coherence between domestic economic policies and the promotion of outward economic orientation is important; successful internationalization strategies build on sound domestic linkages between firms.

In their opening remarks both *NBP* President *Marek Belka* and *OeNB* Governor *Ewald Nowotny* praised the benefits of merging, into a unique joint event, their institutions' well-established event series, which both have a clear focus on future economic integration in Europe.

Belka emphasized that in spite of the numerous challenges Europe is facing today, the EU is not at an adverse turning point. Over the last decades, integration has contributed to the quality of life Europeans enjoy today and has been a major driver of transition, development and convergence in CESEE. But, as Nowotny pointed out, the deepening of the European integration process has not kept pace with EU enlargement. Both speakers thus agreed on two major challenges for Europe:

First, Europe needs a growth spurt to fight unemployment and public debt. Productivity is key for both growth and competitiveness, requiring the right mix of innovation, labor market and product market policies. Nowotny emphasized

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[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2016. Presentations and papers, information about the speakers and the conference program are available at www.nbp.pl.*

that growth also crucially depends on demand. The Eurosystem uses the available policy instruments to support domestic demand.

Second, Europe needs to reduce the uncertainty about the future of monetary integration. The completion of monetary union needs to follow the recommendations of the *Five Presidents' Report*. Several good ideas are already on the table but will need to be developed in more detail and will have to pass the reality check. A fiscal and economic policy framework that combines risk reduction and risk sharing is the precondition for long-term competitiveness.

FDI has an important role in fostering competitiveness

In her keynote address, Professor *Beata Javorcik* from the *University of Oxford* focused on the special role and characteristics of multinational corporations (MNCs). Accounting for a major part of global R&D expenditure, MNCs are important drivers of innovation in the host economies and hence also creators of knowledge. Javorcik convincingly argued that the extent to which this knowledge is transferred to the host economy depends on the competitiveness of local firms. Based on her own research, she showed that such knowledge transfers are not confined to the industry in which an MNC is active – in fact, MNCs have an incentive to prevent their knowledge from leaking to their competitors – but that supplying industries benefit from knowledge spillovers as well. Hence, the market entry of MNCs leads to significant and positive productivity effects and thus stimulates economic growth. Javorcik concluded that investment promotion should focus on sectors that are likely to generate linkages and on R&D activities, where agglomeration effects play an important role especially in CESEE. Links to local suppliers can e.g. be promoted by facilitating access to ISO certifications, while market entry barriers for MNCs can be overcome through active communication.

Knowledge spillovers, product quality, and meeting consumers' demand make firms competitive

The first conference session dealt with the various dimensions of competitiveness. In his introductory words, *OeNB* Executive Director *Peter Mooslechner* cautioned against what Krugman called the "dangerous obsession trap:" the danger of maximizing competitiveness at the cost of living standards through a race to the bottom in terms of production costs. Today, quality aspects increasingly dominate over price and cost factors in the competition for market shares.

The first speaker, *Alain de Serres,* Head of the Structural Policies Surveillance Division at the *Organisation for Economic Co-operation and Development (OECD),* saw productivity as the key channel through which structural reforms can raise growth. While productivity has decelerated in advanced countries since the early 2000s, in the CESEE region it started to slow down only as the crisis unfolded and investment dropped markedly. A high degree of trade openness may be a driver of productivity but is not sufficient to move the CESEE countries up the value chain. Furthermore, productivity growth will crucially depend on knowledge spillovers from exporting firms to domestic firms. These can be supported by policies that encourage knowledge transfers, including pro-competition reforms, policies that promote the collaboration between private firms and universities and policies that increase the mobility of labor and skills.

Hylke Vandenbussche, Professor at the *Katholieke Universiteit Leuven,* focused on four key observations in the recent trade literature. The first has become known as the "Spanish paradox:" the countries with the highest unit labor cost (ULC) growth are often very successful exporters. One key for solving this puzzle is found in microdata: exporters are more innovative, more productive and have lower ULC growth. The second observation is that demand-side factors such as quality or tastes are often underestimated. Focusing primarily on quality is a way to escape the price competition arising from countries such as China or other Asian economies. The third observation is that company size is an important economic factor: countries with a high share of large firms are more successful exporters. The policy advice that follows from this observation is to abolish barriers that prevent firms from growing. The fourth observation is that exporting firms also tend to be importing firms. Blocking imports through trade protection thus lowers exports and therefore competitiveness. Overall, Vandenbussche concluded that it is essential to understand firm-level heterogeneity in order to understand macroeconomic competitiveness.

Julia Wörz, Lead Economist at the *OeNB,* joined the previous speaker in emphasizing the importance of nonprice factors of competitiveness. This helps solve the puzzle that real appreciations are often associated with market share gains. Wörz proposed decomposing the changes in market shares into price and cost factors, nonprice factors, structural factors and factors related to the integration of exporters into global value chains. This latter factor only becomes apparent when the focus switches to the domestic value added included in exports. While this change in perspective does not alter the central observation that northern, western and southern EU Member States have been losing or, at best, maintaining global market shares while eastern EU Member States have been gaining market shares, it changes our understanding of the underlying driving forces: gains in price competitiveness added positively to market share changes in all EU Member States, while gains in nonprice competitiveness by countries in the CESEE region arose largely from the fact that they process higher-quality inputs. Hence, integration into global values chains is beneficial for catching-up economies, but detrimental for advanced economies. Moreover, the results presented show that none of the EU Member States managed to adapt to changes in global demand.

Innovation is necessary in all sectors of an economy

The second session, chaired by *Ardo Hansson,* Governor of *Eesti Pank,* focused on the interaction between innovation policy and competitiveness. In his introductory statement, Hansson emphasized that innovation is a key factor in boosting productivity growth and crucial for the convergence process of the CESEE countries. He highlighted that participation in a monetary union calls for decisive policy action aimed at increasing productivity. Innovation is a way to avoid the need to undergo a painful internal devaluation process.

Dan Breznitz, Director of Academic Research at the *University of Toronto,* outlined that innovation requires a different logic of policymaking since the outcome of innovation projects as well as their potential markets are not known in advance. Therefore, the only possible solution for policymakers would be to stimulate economic agents to produce and define innovative products and processes. However, Breznitz outlined that this might require time and a "trial and error" strategy that includes admitting and correcting wrong policy decisions. As an example he cited the acquisition of skills, both through formal education and firm-specific training.

Uri Gabai, Director at the Office of the Chief Scientist of Israel's *Ministry of Industry, Trade and Labour,* presented Israel as a success story of 40 years of continuous innovation policy. He emphasized the Israeli government's clear signal that innovation was the only viable business model. Another key policy was the government's strategy to stick to the fundamentals while closely analyzing market failures. Gabai concluded that innovation policy works, but that it needs a systematic approach, room for experimentation and patience.

Gilles Rabin, Associate Researcher at the *University of Grenoble,* underlined that innovation rests on three major pillars: a clear focus, consumer choice and political choice, including what he referred to as "digital colonialism." As for the first, only 13 European regions currently invest more than 4% of their GDP in R&D. Rabin suggested that innovation policy should focus on the best performers and thus apply "negative" discrimination. Furthermore, as consumers drive the market, policymakers should foster and accelerate the actual implementation of innovations in production. In addition, he stressed that often the policy choice is to support foreign companies operating in the respective country, which he considered to be a very alarming development. Finally, Rabin called for a common European response to "digital colonialism" by focusing on the development of a European innovation policy that holds against the U.S. equivalent and subsequently linking this European innovation policy to the respective production processes.

In the ensuing discussion, the speakers outlined that clear strategies are needed to promote innovation activity. In addition, business environment regulations should be improved to allow for smooth market entries and exits. Moreover, increasing competitiveness would require stronger support for the best universities, regions and firms; however, the discussants concluded that these measures would be rather unpopular.

Labor market policies must take account of the social dimension

Mehmet Yörükoğlu, Deputy Governor of *Türkiye Cumhuriyet Merkez Bankası,* opened the session on labor market issues by pointing out that a country's labor market situation reflects its competitiveness. He stressed the structural nature of unemployment in a range of countries and asserted that a reallocation of employment was needed to reduce the current skill mismatch without damaging society and economic growth.

Detlef Eckert, Director at the *European Commission,* outlined the importance of cost competitiveness and the need for adjustments at the cost level. He emphasized the value added of new evidence from microdata and called for translating micro-evidence into macropolicies. He stressed the efforts the European Commission made in the framework of the European Semester and outlined the currently debated issue of "flexicurity" in the recently published *Five Presidents' Report,* i.e. the combination of a more flexible labor market and effective active labor market policies. In addition, the development but also the extraction of skills would be intrinsic to the EU's competitiveness agenda. He concluded by saying that the European Commission is currently taking steps to further boost competitiveness by actively promoting the establishment of national Competitiveness Boards in parallel to developing the social dimension of Economic and Monetary Union (EMU).

Michał Gradzewicz, Director at the Economic Institute of *Narodowy Bank Polski,* touched upon the connection between employment and productivity growth by comparing several CESEE EU countries and the euro area. He related the slowdown of productivity growth, especially its trend, to the educational and contractual structure of the labor force. In particular, he outlined that in the CESEE countries the increase in productivity was not accompanied by a strong increase in tertiary-educated employment. In contrast, in selected euro area countries, productivity increases went broadly hand in hand with an increase in the employment of persons that have completed secondary education. Moreover, he stressed that employment creation in CESEE mainly came from an increase in temporary contracts (only exception: Hungary), while employment on the basis of permanent contracts grew in the euro area.

Peter Sinclair, Professor at the *University of Birmingham,* contrasted the accumulated loss of employment in the 19 euro area countries with the gain of employment in the non-euro area Member States. He also pointed out that the Philips curve relation – a negative link between inflation and unemployment – was still observable in the United States and to some extent in the smaller euro area countries but not in the euro area as a whole. Claiming that a fiscal devaluation is possible in EMU despite failures in fiscal policies in recent years, he suggested a combination of employment subsidies and VAT increases to restore euro area competitiveness. He concluded that increasing fiscal sustainability in the EU would require a profound reform of Member States' social security systems so as to foster labor mobility.

In the ensuing discussion, participants touched upon the importance of introducing single-labor contracts to prevent a segmentation of the EU labor market – highly paid workers in stable jobs and workers in low-paying precarious positions – and to enhance labor market flexibility. Moreover, the problem of noninterference between the envisaged national Competitiveness Boards at the EU level and the national wage-setting authorities was debated.

CESEE countries benefit from sound fundamentals

The session on structural policies was chaired by *Marina Wes,* Country Manager with the *World Bank.* She stressed that European demography is at a turning point, which calls for urgent structural policy interventions.

The first speaker, *Zsolt Darvas,* Senior Fellow at *Bruegel,* touched upon the effectiveness of EU economic governance for both the euro area periphery and CESEE. While highlighting their similarities in terms of the magnitude of capital inflows, he also pointed toward differences such as the composition of capital inflows, the degree of misalignment between wages and productivity growth, and the share of foreign bank ownership. In his view, structural policies would be one of the possible strategies to increase economic growth in both regions. However, he questioned the effectiveness of both pre-crisis economic governance by the European Commission and the current framework of the European Semester.

Daniel Gros, Director at the *Centre for European Policy Studies,* looked into both the external and internal dimension of competitiveness. He pointed out that with respect to external competitiveness the enlarged EU maintained its position both in the manufacturing and services sectors. However, despite large structural reform programs, EU economic performance has deteriorated, implying challenges for internal competitiveness. He concluded that the careful design and implementation of structural reforms is the key to their success.

Brian Pinto, former Senior Advisor at the *World Bank,* defined structural policies as the residual which is addressed when policymakers have exhausted monetary, fiscal and financial policies. With the aim of defining an appropriate strategy for structural policies, he reviewed several recent policy papers. Overall, the economic advantage of the United States is the result of structural reforms that were implemented before the global economic crisis. In addition, the lack of fully centralized and coordinated fiscal and financial institutions impeded the effectiveness of structural reforms in the EU. He concluded that the CESEE countries could benefit from relatively good governance and institutions and a limited debt overhang; however, they should focus on adopting best practices.

Michał Rubaszek, Economic Advisor at the Economic Institute of *Narodowy Bank Polski,* discussed how EU structural policies are related to the adoption of the euro in CESEE. He focused on two key issues to define the success of euro adoption, namely a country's institutional set-up and the fundamentals in place. As for fundamentals, the CESEE countries enjoy a relative advantage e.g. due to lower wages and a well-trained labor force. However, he also saw ample room for improvement and for fostering innovation in CESEE by enhancing and using the current and future EU institutional infrastructure. He highlighted that the EU CESEE countries assigned to adopt the euro should be assured that the benefits of euro adoption outweigh the costs of giving up the current exchange rate flexibility.

In the discussion following the presentations, participants outlined that structural policies should not be expected to deliver too much, as they seemed to have touched only upon the surface so far. In addition, they highlighted that structural policies should be complemented by more focused fiscal policies in the EU and more balanced country-specific recommendations by the European Council.

The euro played a stabilizing role during the crisis

In his dinner speech, *OeNB* Governor *Nowotny* discussed monetary policy challenges before, during and after the global financial crisis, pointing out that the pre-crisis period had been characterized by policy mistakes. One major mistake was that convergence criteria did not sufficiently refer to real economic developments and aspects of sustainability. Low real interest rates added to excessive spending and contributed to diverging economic developments in the euro area countries.

The effects of these policy failures fueled the pace of the crisis. In this period, EMU proved to be an essential element of stabilization. The key contribution of European monetary policy was to sustain the availability of financing for the banking system. The benefits were significant not only for the euro area, but also for its neighboring countries: After all, access to financing and financial know-how had been a major driver of the convergence process in CESEE and a key factor for competitiveness.

Now that the crisis has been mastered, nobody doubts that the euro is here to last. The remaining major challenge for the euro area is to fight unemployment. This requires primarily measures to stimulate growth and productivity, but also labor market policies to ensure the quick transmission of economic growth to employment. According to Nowotny, in our approach to employment we need to stick to the "European way," by combining aspects of flexibility and security instead of following a hire and fire approach.

Persistent current account imbalances need to be addressed

In his keynote address, *Michael Landesmann,* Director of Research at the Vienna Institute for International Economic Studies (wiiw), highlighted some major challenges for the European integration process related to competitiveness. The process of economic integration has led to rising external imbalances in Europe's low- and medium-income countries. According to Landesmann, these imbalances reflect a persistent weakness of the tradable sector in these countries and may thus become a stumbling block for future integration. There are various problems in resolving these imbalances, e.g. past de-industrialization trends, agglomeration trends (which induced diverging patterns of industrialization between the central European manufacturing core and peripheral countries), an insufficient policy focus on the tradable sector and a conflict of policy instruments (e.g. between competition policy and industrial policy). He further claimed that the role of the real effective exchange rate in this context is not always well understood. A real appreciation may reflect previous good trade performance rather than drive future trade performance. Further, in the traditional measurement of real effective exchange rates, quality improvements are ignored. Taking a forward-looking stance, he identified the following areas as important determinants of competitiveness: moving toward products with higher income elasticity, building sufficient export capacity and diversifying export structures to reduce vulnerabilities.

In the general discussion, Professor Landesmann advocated a combination of industrial policies at the national and the EU level similar to structural funds that helped build production capacities. He agreed that the problem is symmetric, i.e. the necessity to reduce imbalances is equally high for surplus countries such as Germany as it is for deficit countries among the low- and medium-income countries. With regard to the rising importance of global production networks, which may require a diversified service sector and a reorientation toward a "tradable sector policy" instead of a narrowly focused industrial policy in manufacturing, he referred to the strong interconnectedness between manufacturing exports and tradable services.

Challenges of a complex global economy

The last conference session focused on the impact of global production networks or global value chains (GVCs). As the session's moderator, *OeNB* Director *Doris Ritzberger-Grünwald,* pointed out, about 60% of world merchandise trade these days is trade in components. Hence, the international fragmentation of production and a country's integration in these global production networks is a major factor of competitiveness.

Filippo di Mauro, Senior Advisor at the European Central Bank (ECB), presented selected results from the ECB's Competitiveness Research Network (CompNet), which he chairs. Modern, complex structures of the world economy require new data that map these complexities: Traditional trade figures are increasingly inaccurate and plagued by double counting, as they ignore the distinction between a country's exports and the country's value added in those exports.

Empirical research shows that foreign value added in exports is increasing over time and is highest in euro area and Chinese exports. Yet, trade integration remains mostly regional, especially within the euro area. The new value added data open new perspectives on the effects of trade on the respective economies: With respect to employment effects, he explained two new concepts, GVC income and GVC jobs. While Germany's gross exports of manufactured goods doubled between 1995 and 2008, the sum of German value added in those export goods (=GVC income) grew only by 7%. In contrast, exports often create jobs in service industries related to exporting (GVC jobs), and these jobs are usually not ascribed to export activities. With respect to shock transmission, di Mauro noted that GVC integration has both accelerated and dampened the transmission of shocks. He concluded by stressing the fact that increases in intra-euro area external imbalances in value added terms are considerably smaller than in traditional gross trade terms.

Robert Koopman, Chief Economist at the *World Trade Organization (WTO),* recalled that the theoretical concepts used to analyze trade in value added do exist, but that finding appropriate data sources can be a problem. He emphasized the importance of investigating not only the global, but also the domestic fragmentation of export production. After all it is firms that actually trade and not countries. This is a field we know even less about, which means we risk missing a big part of the picture. Presenting some of his research results, he confirmed that traditional measures of competitiveness – such as the revealed comparative advantage – can be very inaccurate and often ignore the contribution of domestic services to final exports. He also explained that the recent drop in the elasticity of global trade vis-à-vis global income can be largely explained by the difference between gross and value added in trade. In conclusion, he re-emphasized the importance of investigating the contribution of domestic firms to export production as their contribution can play an even more important role for competitiveness than the integration of exporters into global production networks.

Linda Yueh, Fellow in Economics at the *University of Oxford,* focused her presentation on China, an economy which is strongly integrated into GVCs. She noted that China's economic growth has been extremely uneven since the start of transition and that an important part of China's catching-up was attributable to the country's opening-up to trade. As such, China's WTO accession in 2001 had a major impact and boosted its share in global trade. In her view, China is now near the middle-income trap, a stage which only 17 countries have surpassed in the post-World War II period and which Chinese policymakers are determined to overcome. According to her calculations, total factor productivity has added between 30% and 40% to Chinese growth, a third of which stems from human capital and another third from innovation in the broader sense. However, a large part of China's innovation has to be attributed to imitation. In line with the previous speaker, Yueh postulated that China had already been industrialized before opening up to trade. China's controlled and targeted internationalization was therefore successful; in addition it was quick, very controlled and strictly targeted. For example, FDI was used to produce positive spillovers and acquire know-how in special exporting areas, which fostered upgrading. Yueh concluded by highlighting China's role in international trade. As the biggest player in global trade since 2008, the country has a substantial impact on trade dynamics. Since 2003

China has pursued an active outward FDI strategy based on the rapid growth of Chinese firms or on the acquisition of foreign firms. In Yueh's view, China continues to build its growth strategy on exports and will probably deploy more aggressive internationalization strategies in the future.

In the general discussion, Pinto referred to the rather skeptical view of GVC trade presented in the *IMF's* most recent *World Economic Outlook,* which states that much of global trade is still traditional one-way trade. With respect to newly arising policy implications, Koopman called for a careful analysis of domestic impediments to integration (such as barriers to entry or exit of firms or inadequate regulation).

"Crystal Ball" panel on CESEE's contribution to euro area and European growth

The "Crystal Ball" panel is the traditional closing session of the CFEE series and is, by definition, future oriented. The moderator, *Boštjan Jazbec,* Governor of *Banka Slovenije,* stressed in his opening statement that the CESEE countries have done better after the crisis than the EU average. At the same time, they are struggling to overcome legacies, reflected in particular in enterprises' trouble to obtain sufficient financing. Looking forward, he highlighted the question whether the CESEE countries will develop into forerunners or will be rather dedicated followers of other EU countries.

Bas B. Bakker, Senior Regional Resident Representative of the *International Monetary Fund (IMF),* stressed that as a result of ongoing convergence, there is no longer a clear divide between East and West in regional EU income levels. In the past 15 years, convergence benefited from sharply increasing employment rates, particularly where the working-age population has been on the decline. In parallel, productivity has gone up, but still remains relatively low. In the future, there will be less room for further increases in employment rates. Instead, productivity growth and further structural transformation will be key. From 2016 to 2030, population aging will imply that the working-age population will shrink faster than the total population. Hence, strong growth of productivity (GDP per working-age person) will be necessary to achieve a moderate growth of GDP per capita, which in turn implies an even lower growth rate of total GDP. Drawing a comparison between growth in Japan and the U.S.A., he pointed out that it was only through far higher labor productivity growth that Japan could achieve a GDP per capita growth that was roughly similar to that in the U.S.A. from 2000 to 2015, while Japan's total GDP growth was substantially lower than in the U.S.A. Assuming an annual labor productivity growth of 2.25% in CESEE in the period from 2016 to 2020 (like in the period from 2011 to 2015) as well as an unchanged employment rate would imply GDP per capita growth of around 1.5% and headline GDP growth of 1% only.

Boris Vujčić, Governor of *Hrvatska narodna banka,* stressed that within-sector reallocation toward more productive firms can generate substantial aggregate productivity gains also in CESEE countries, which are characterized by a large number of low-productive firms and very few high-productive firms. From his point of view, structural reforms are the most promising path to spur growth. However, significant economic gains of these reforms emerge only in the medium to long run. Apart from product and services market reforms and labor market-related education and tax reforms, growth could be supported through improvements in the quality of public finance.

Iain Begg, Professorial Research Fellow at the *London School of Economics and Political Science,* commented that CESEE countries' outward FDI may become increasingly important in the future, implying changes in CESEE's position in cross-border supply networks. It is time to rethink sectors and specializations in order to fully benefit from the knowledge economy, and to exploit sources of innovation beyond R&D. As one key area of uncertainty he stressed brain drain, which often leads to "brain squandering" due to overqualification. In policy terms, he insisted that structural reforms should increasingly focus on the promotion of growth.

In the ensuing panel discussion, Bakker pointed to easy access to venture capital as one major reason why Apple and Google emerged in the U.S.A. and not in the EU. Moreover, he highlighted the need to avoid boom-bust cycles and procyclical policies in order to achieve sustained catching-up growth. The audience raised the question to what extent there is a tradeoff between productivity and social cohesion. Begg underlined the importance of "social investment," citing the Nordic countries where early investment forestalls future problems.

In his closing remarks, NBP Governor Belka emphasized how rich the CEEI/CFEE 2015 had been in terms of presented data, questions raised, suggestions and recommendations. Expressing his thanks to the OeNB for the smooth and successful cooperation, he pointed out that the conference's success was largely attributable to the joining of forces of NBP and the OeNB. With reference to the conference title, "Boosting EU competitiveness," he explained that, in order to achieve a boost in competitiveness, it is important that the EU uses its resources more efficiently. The European economy cannot grow only through exports. For improving allocative efficiency, the EU, including the CESEE Member States, would be well advised to look at the example of the Nordic countries when it comes to labor market policies and the United States when it comes to the financing of venture capital.